No. 21,169

In the

United States Court of Appeals

for the Ninth Circuit

A. Bates Butler, Trustee of Construction Materials Co.,

Appellant,

vs.

Pacific National Insurance Company, nka Transamerica Insurance Company,

Appellee.

On Appeal from the United States District Court for the District of Arizona

Answering Brief of Appellee

Chandler, Tullar, Udall & Richmond
1110 Phoenix Title Building
177 North Church Avenue
Tucson, Arizona 85701

Attorneys for Appellee

SORG PRINTING COMPANY OF CALIFORNIA, 346 FIRST STREET, SAN FRANCISCO 94105

TABLE OF CONTENTS

TABLE OF AUTHORITIES CITED

Cases

Statutes

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PREFATORY NOTE

Throughout this brief, appellant is referred to as "Trustee;" Construction Materials Co. as "Construction;" The Ashton Company, Inc., as "Ashton;" State of Arizona as "State," and appellee as "Pacific."

Most of the ultimate facts in the trial court were undisputed, and were made part of the record by a written Stipulation filed January 7, 1966, which stipulation is designated as document No. 15 in the Clerk's Certificate to Record on Appeal, and begins at page 41 of the Transcript of Record on Appeal. It is cited hereinafter as "Stipulation."

JURISDICTIONAL STATEMENT

While Trustee invoked the jurisdiction of the United States District Court for the District of Arizona under the provisions of Title 11 USC Chapter 7, § 110 and amendments thereto, § 70 of the Bankruptcy Act (Complaint), the court found as a fact diversity of citizenship and that the amount in controversy exceeded the sum of $10,000.00, exclusive of interest and costs (Stipulation; Findings of Fact No. 1), basing its jurisdiction on Title 28 USC Chapter 85, § 1332. Jurisdiction of this court on appeal is asserted under Title 11 USC Chapter 4, § 47.

STATEMENT OF THE CASE

Pacific apprehends the undisputed facts germane to this appeal to be as follows:

Construction and State entered into a construction contract on or about July 28, 1963, which contract (Exhibit 2 in evidence) expressly included a surety bond (Exhibit 1 in evidence) executed by Construction as principal and Pacific as surety. One of the conditions of the bond portion of the contract was that Construction "shall promptly pay . . . all laborers, mechanics, subcontractors and material men . . ."

The bond was executed on behalf of Pacific by Sol Ahee; Ahee would not have done so in the absence of a certain General Agreement of Indemnity dated November 19, 1962 (Exhibit 19 in evidence). Nominal parties to the indemnity agreement were Construction and American Surety Company of New York, but Ahee had been informed by the bond superintendent for Transamerica Insurance Group that it was equally binding for Pacific which, like American Surety Company, was a member of the Transamerica Insurance Group (Stipulation, pages 45-46, Transcript of

Record on Appeal). Pertinent portions of the General Agreement of Indemnity provided as follows:

> "EIGHTH—That in the event any such bond be given in connection with a contract of the Indemnitor (Construction) for construction work . . . Indemnitor further agrees in the event of any breach or default on his part in any of the provisions of said contract and/or bond that the said Company, shall be subrogated to all the rights and properties of the Indemnitor in such contract, including deferred and reserved payments, current and earned estimates and final payments, and any and all moneys and securities that may be due and payable at the time of such default on said contract."
>
> "THIRTEENTH—That all the terms and conditions of this agreement shall stand for the protection of . . . any other surety procured by the American Surety Company of New York . . ."

Construction began work under the contract on or about July 8, 1963, and entered into a written agreement (Exhibit 4 in evidence) on or about November 1, 1963, for Ashton to complete the work as a subcontractor.

On November 22, 1963, by registered letter (Exhibit 10 in evidence), Harold S. Cole, claim manager for Transamerica Insurance Group, asked State not to release any funds remaining for disbursement under the contract to anyone other than Ashton or Pacific, in order to secure payment to Ashton, and enclosed a copy of the said General Agreement of Indemnity. The letter and copy of the indemnity agreement were acknowledged by State under date of November 26, 1963 (Exhibit 11 in evidence).

On or about November 22, 1963, Construction voluntarily filed a petition in the District Court of Arizona for relief under Chapter XI of the Bankruptcy Act. A receiver was appointed on November 26, 1963, and subsequent to the

latter date Construction was adjudicated a bankrupt and Trustee was duly appointed and qualified as its trustee in bankruptcy.

Ashton completed work under the construction contract on or about December 3, 1963, and so advised State the following day (Exhibit 5 in evidence), asking State to withhold any payments that might be due Construction pending submission of a claim by Ashton for the cost of completion. On or after December 31, 1963, Ashton rendered a statement to Construction under the November 1 agreement in the total sum of $33,238.60 for labor, materials and equipment; on or about January 21, 1964, Ashton made demand on Pacific for payment of the claim under the terms of the surety bond, and by letter dated February 10, 1964, Ashton made claim for the same amount against State (Exhibit 6 in evidence). On or about May 13, 1964, Pacific paid the sum of $31,000.00 to Ashton in full settlement of the latter's said claim (Exhibit 8 in evidence).

At all material times, State retained under its said construction contract with Construction the sum of $21,557.27, which sum is the subject of this controversy. The Arizona Highway Department Standard Specifications, July, 1960 (Exhibit 3 in evidence), expressly made a part of the said construction contract, provided in part:

> "9-6 Partial Payments: . . .
>
> The State may also deduct from any monthly earned statement the amount of any unsatisfied claim against the contractor for labor or materials . . . the contractor may be allowed a portion of this suspended payment, provided the State shall at all times retain an amount sufficient to enable it . . . to cover unsatisfied claims." (Page 42, Exhibit 3 in evidence).
>
> "9-8 Acceptance and Final Payment: . . .
>
> . . . Before the time of payment of said final statement, the contractor shall submit evidence satisfactory to the

engineer that all payrolls, invoices of materials, bills and outstanding indebtedness of whatsoever nature incurred in connection with this work have been paid." (Page 44, Exhibit 3 in evidence).

Pacific at trial contended that its rights as surety, having paid the unsatisfied claim of Ashton for labor and materials, were superior to those of Trustee to the funds retained by State under any or all of the following theories:

1. It was subrogated to the rights of Construction under the said construction contract as of the date of the contract, June 28, 1963.

2. It was subrogated to the rights of State to the retained funds.

3. It was subrogated to the rights of Ashton to be paid out of the retained fund.

4. It acquired an equitable lien on the retained funds at the time it executed the surety bond, by virtue of the General Agreement of Indemnity.

5. It was entitled in its own right, as surety on the bond, to the benefit of security held by State as obligee.

The court decided (Decision, page 51, Transcript of Record on Appeal) that State had the right to retain and withhold from Construction the amount of any labor and material claims remaining unpaid from Construction, and the right to use such retained funds to pay unpaid laborers and material men; that Ashton furnished labor and materials for which it was not paid by Construction and had a right to be paid by State out of the funds retained and withheld from Construction; that Pacific, having paid Ashton, was entitled to Ashton's rights to the extent to reimburse it; and that, since Pacific had paid out more than the amount of the funds retained by State, Pacific had the right to recover such amount. Findings of fact and conclusions of

law in accordance with said Decision, and judgment that Trustee take nothing by his Complaint, and that the sum of $21,557.27 which State had deposited in the District Court's registry fund to abide the outcome of the action be paid to Pacific, were entered on April 6, 1966. Trustee's appeal followed.

ARGUMENT

At the outset, it is submitted that Construction acquired no right to the retained funds because of its breach of the condition that it "shall promptly pay . . . all laborers, mechanics, subcontractors and material men" (Exhibit 1 in evidence) and/or its failure thereafter to pay the above-described claims as principal under the bond portion of the contract, which payment by the contractor also was a condition on State's obligations under the payment provisions of the contract.

Pacific, having performed, as it was required to do as surety, following Construction's breach, is subrogated to the rights of Construction to the retained funds as of the date of the contract. *Prairie State National Bank v. United States,* 164 U.S. 227, 41 L ed 412, 17 S Ct 142 (1896).

Further, by having paid the unpaid laborers and material men, Pacific is entitled to subrogation to the right of State to retain the funds for completion of the contract, including the payment of such claims. *Henningsen v. United States Fidelity & G. Co.,* 208 U.S. 404, 52 L ed 547, 28 S Ct 389 (1908).

The rules of the two cases above cited were expressly reaffirmed as recently as 1962 in *Pearlman v. Reliance Insurance Company,* 371 U.S. 132, 9 L ed 2d 190, 83 S Ct 232 (1962), on facts very similar to the case at bar, in that there was a dispute over funds withheld by the government, involving the trustee in bankruptcy of a government con-

tractor and the contractor's payment bond surety which had paid claims in excess of the funds withheld. In holding for the surety, the court went even further than the Prairie Bank and Henningsen cases, expressly holding that the laborers and material men had a right to be paid out of the retained fund, as well as holding that the government had a right to use the retained fund to pay such laborers and material men, and that the contractor, had he paid his laborers and material men, would have become entitled to the fund. The surety, having paid the laborers and material men, was held entitled to the benefit of all the foregoing rights to the extent necessary to reimburse it.

In a separate concurring opinion in the Pearlman case, three justices chose to reach the same result without enlarging the rule of Prairie State and Henningsen, on the basis of subrogation to the rights of the government to surplus funds remaining in its hands after the contract was completed, and also relying on *Martin v. National Surety Co.*, 300 U.S. 588, 81 L ed 822, 57 S Ct 531 (1937). The latter case was decided in favor of the surety on the basis of an assignment by the contractor, in his written application for the surety bond, of the payments on the contract to the surety in the event of any breach or default in the contract. The rule of the Martin case also seems applicable herein, in light of the language in the agreement of November 19, 1962, between Construction and American Surety Company of New York, whereby the former agreed in the event of any breach or default on its part in any of the provisions of a construction contract and/or bond that the surety should be subrogated to all rights and properties of Construction in such contract, including deferred and reserved payments. The stipulated testimony of Sol Ahee establishes that Pacific executed the bond in question in reliance on and, in part, in consideration of this covenant,

which under the terms of the indemnity agreement is extended to "any other surety procured by the American Surety Company of New York." State received actual notice of the agreement and Pacific's rights thereunder on or before November 26, 1963.

As a fifth basis for establishing a right superior to Trustee in the retained funds, Pacific asserted at trial an independent right as surety to the benefit of security held by the obligee on the surety bond. See *Hochevar v. Maryland Casualty Co.,* 114 F 2d 948 (1940).

Thus, Pacific relied both on the various equitable rights of a surety defined in the Prairie State, Henningsen and Pearlman cases; an equitable right created by the agreement of Construction (Exhibit 19 in evidence), and the independent right of a surety, enunciated in Hochevar, to the benefit of the contract security.

The trial court based its decision in favor of Pacific on the doctrines enunciated in Pearlman, Prairie State, and Henningsen (Decision, page 51, Transcript of Record on Appeal) and its Findings of Fact and Conclusions of Law are consistent with the doctrines enunciated therein.

Trustee now chooses to base his appeal solely on the opinion in *Adamson v. Paonessa* (Calif., 1919) 179 Pac. 880. The case is wholly inapplicable for the following reasons:

1. It arose under the California Improvement Act of 1911; the court expressly distinguished the case from the line of authorities beginning with *Prairie State National Bank v. United States,* 164 U.S. 227, 41 L ed 412, 17 S Ct 142 (1896), on the grounds that payment under the Improvement Act was to be made, not by the person, public or private, by whom the contract was made, but by a number of different persons not parties to the contract, each of whom pays independently his separate share of the amount due. The court contrasted this with a situation

where the material men and laborers had a right as against a certain fund in addition to any recovery against the contractor or his surety, and agreed that in the latter circumstances the surety upon payment of claims would be subrogated to the claimants' rights against such fund; it based its holding on the absence of such a fund under the Improvement Act contract. Trustee asserts that this case is similar to Paonessa in that there is no such fund involved; the facts, however, belie Trustee's position and the district court so found and concluded. The pertinent portions of A.R.S. § 34-221 governing employment of contractors for public buildings and improvements at all times material hereto read as follows:

> "A. The agent shall enter into a contract with the lowest responsible bidder whose proposal is satisfactory, the terms of which shall include the following items:
>
> * * * * * * *
>
> 3. Ten per cent of all estimates shall be retained by the agent as a guarantee for complete performance of the contract, to be paid to the contractor within sixty-five days after completion or filing notice of completion of the contract, *provided the contractor has furnished the agent satisfactory receipts for all labor and material bills* and waivers of liens from any and all persons holding claims against the work." (Emphasis supplied).

The foregoing is the successor to the statute urged unsuccessfully in *Webb v. Crane Co.*, 52 Ariz. 299, 80 P.2d 698 (1938), as indicating the applicability of the mechanic's lien law to public buildings. In that case the court held that such application could not be founded upon mere inference, but required unequivocal legislative action; the holding, however, in no way affects the clear expression of legislative

intent evidenced in the 1956 enactment, quoted above, that the ten per cent retained by the contracting agent (defined in A.R.S. § 34-101 as "any state or county officer, board, commission or other governmental agency or person") is at least in part a fund for the benefit of unpaid material men and laborers. The statute requires retention, and inserts as a condition of final payment the submission of receipts for all labor and material bills. Pursuant to the foregoing statute, the payment provisions of the contract in this case provided for retention of ten per cent, and for the deduction as well of "the amount of any unsatisfied claim against the contractor for labor or materials." (Page 42, Exhibit 3 in evidence). The circumstances of the instant case, therefore, clearly fall under the line of authorities including *Prairie State National Bank v. United States,* 164 U.S. 227, 41 L ed 412, 17 S Ct 142 (1896), *Henningsen v. United States Fidelity & G. Co.,* 208 U.S. 404, 52 L ed 547, 28 S Ct 389 (1908), and *Pearlman v. Reliance Insurance Company,* 371 U.S. 132, 9 L ed 2d 190, 83 S Ct 232 (1962), rather than the Paonessa case which distinguished Prairie State because payment under the Improvement Act was to be made "by a number of different persons not parties to the contract" and because there was no fund against which the material men and laborers had any right.

2. The Paonessa case involved a dispute between the surety and an assignee "without notice of any prior assignment to the surety company and in complete ignorance of it," who advanced certain sums of money to the contractor in reliance on an assignment of all of the contractor's rights under the contract; the instant case involves a dispute between the surety and the contractor's trustee in bankruptcy. Rights asserted by the surety in *Adamson v. Paonessa* and in the instant case depend on equitable doctrines, hence the relationship of the parties and their knowl-

edge of the circumstances at material times are essential facts in determining the result of each case. Trustee suggests this in pointing an accusing finger at Pacific on page 7 of his Opening Brief for failure to verify or check the financial standing of Construction at the time the surety bond was executed in June, 1963. Contrast this failure with Construction's conduct in entering into the agreement of November 1, 1963 (Exhibit 4 in evidence) for completion of the work and thereby submitting Pacific to exposure on its surety bond for the cost of such completion, only twenty-two (22) days before the filing of the voluntary petition for relief under Chapter XI of the Bankruptcy Act. To permit the principal on the surety bond by its own act with full knowledge of its circumstances to employ another to perform under its contract, to place that other in the position of a secured creditor because of Pacific's obligations as surety, and simultaneously to limit Pacific's position to that of a general creditor in the ensuing bankruptcy, would run directly contrary to the basic principles in equity of natural justice and essential fairness without regard to form, by which that which should be done is caused to be done.

3. Because of the disparity in the identity of the disputing parties, the giving of notice or failure to give notice, on which the Paonessa case also turned, may be without application here. In any event, it is undisputed that Pacific gave notice to State by letter dated November 22, 1963 (Exhibit 10 in evidence) of its rights (as a "surety procured by the American Surety Company of New York . . .") under the indemnity agreement of November, 1962, prior to completion of the work and any right to payment arising therefrom. Unlike the Paonessa case, however, this action does not involve the claim of an assignee "without notice of the prior assignment and in complete ignorance of it."

In summary, Trustee's brief, from the Specification of Error to the Conclusion, is based on a misconception of the ultimate issue herein. While Trustee asserts that Pacific is trying to become a secured creditor of a bankrupt estate, the true issue is whether Pacific, like the surety in the Pearlman case, acquired rights to the retained fund superior to those of Trustee, Construction, or the latter's general creditors. Construction, by terms of the surety bond in its contract with State if by no other provision, promised to pay all laborers and material men on said contract. It failed to do so and Pacific as surety was required to satisfy unpaid claims for labor and material in excess of the funds retained under the contract by State. Construction, thus having breached its contract, never became entitled to those funds, whereas Pacific by its performance acquired the right thereto, be it by subrogation to the rights of the principal on its bond, the unpaid claimants, the State of Arizona, or the assignment in the General Agreement of Indemnity. The judgment of the trial court should be affirmed.

Respectfully submitted,

CHANDLER, TULLAR, UDALL & RICHMOND
By JAMES L. RICHMOND
Attorneys for Appellee

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

JAMES L. RICHMOND